RB-2002-01 Guidance on Brokered Certificates of Deposit

BACKGROUND

Recent actions by the Securities and Exchange Commission (SEC) against Robert L. Bentley, Entrust Group, and Bentley Financial Services, Inc. (collectively, Bentley), serve as a warning about fraudulent investment activities. On October 23, 2001, the SEC filed suit against Bentley for suspected securities fraud. Bentley allegedly committed fraud in the sale of securities to financial institutions and to individual investors. Specifically, the SEC alleges that Bentley was representing to investors that they (Bentley) were selling federally-insured certificates of deposit (CDs) when, in fact, they were selling uninsured securities issued by Bentley. The SEC also alleges that Bentley had to attract new investors in order to repay previous investors. The Philadelphia District Court issued a Temporary Restraining Order against Bentley that freezes Bentley's accounts and appoints a receiver to exercise control over Bentley's assets.

PURPOSE

The purpose of this Bulletin is to reemphasize the importance of closely scrutinizing all aspects of a financial transaction, including those perceived to contain little or no risk. In the case of Bentley, investors may have failed to follow fundamental safety and soundness principals. Discussed below are principal areas of concern regarding brokered CD activity.

DEPOSIT BROKERS

CDs have traditionally filled the demand for lower-risk investments; however, declining interest rates have complicated efforts to maintain satisfactory yields. While insured depository institutions directly offer CDs, many brokerage firms and independent salespeople also offer these types of deposits. These individuals and entities, known as "deposit brokers", can sometimes negotiate a higher rate of interest by promising to bring a certain amount of deposits to the institution. The deposit broker then offers these "brokered CDs" to his or her customers.

Many credit unions do not realize that there are no federal or state licensing requirements for deposit brokers. Anyone from a person working alone at home to someone affiliated with a major financial services company can be a deposit broker. This situation places a greater burden upon the potential credit union investor to fully investigate the credentials and qualifications of the deposit broker and the credibility of

the transaction.

The burden of investigation and due diligence before committing credit union funds to any investment remains with the credit union's Board of Directors. Credit unions that rely on third parties for the purchase, settlement, or holding of any type of investment should perform routine screening checks into the qualifications and backgrounds of these individuals and entities. One of the initial actions taken before acquiring brokered CDs should involve determining whether the deposit broker is, or is required to be, registered with the SEC and/or the State Securities Board. Registration and certain background information can be obtained from the National Association of Securities Dealers (NASD). Brokers registered with the SEC will be listed in the NASD Central Registration Depository (CRD) and will have a unique number. The CRD can be accessed via the Internet at www.nasdr.com

"about your broker", or at NASD Regulation's Public Disclosure toll-free Hotline at (800) 289-9999. Additional information may also be available from the State Securities Board at (512) 305-8300 or www.ssb.state.tx.us, the Secretary of State at (512) 463-5701 or www.sos.state.tx.us, or the local chapter of the Better Business Bureau.

OWNERSHIP

Commission Rule 91.804 requires a credit union that invests funds in a CD to hold such CD in the name of the credit union. This means that the issuing institution's records must indicate the credit union as owner of the investment and not the deposit broker.

FRACTIONALIZED INVESTMENTS

In some instances, brokered CD purchases involve one or more jumbo CDs, which are federally insured, but are resold as "fractionalized" investments using the pool of CDs as collateral. Credit unions may be misled into believing that they are buying the CDs themselves when in fact they are simply making an investment with the broker. At the present time, neither the Texas Finance Code nor the Commission Rules authorize a credit union to purchase this type of security.

SAFEKEEPING

A credit union's purchased investments must be in its possession or held by a board-approved safekeeper under a bailment for hire contract. Any safekeeper used by a credit union must be regulated by either the SEC or a federal or state financial institution regulatory agency.

DOCUMENTATION/VERIFICATION

Brokered CDs may carry unique characteristics. These investments could be "zero coupon" instruments, reflect a

long-term maturity, contain a "call" provision benefiting the issuer, and/or may be quoted in simple interest rates. Unscrupulous brokers attempt to cover these undesirable features by omitting certain information, using small print, or even offering to repurchase the investment to indicate liquidity. Listed below are some of the basic characteristics of a brokered CD that should be determined through documented confirmation or verification with the issuer:

- Maturity Date Credit unions should confirm the maturity date and require verification in writing.
- Call Feature(s) Callable CDs give the issuing institution the right to terminate or "call" or redeem the CD after a set period of time. The call is established for the benefit of the issuer and mitigates the issuer's exposure to interest rate risk.
- Interest Rate Credit unions should require a disclosure statement that specifies the interest rate and whether it is fixed or variable. Interest rates should be thoroughly analyzed and understood. Decisions between investment options are difficult to analyze if yields are not comparable. Bond equivalent yield is the industry convention for comparing yields and should be adopted by your credit union.

BOARD-APPROVED WRITTEN POLICIES

The credit union's Board of Directors should approve comprehensive policies and procedures regarding the use of brokered CDs. Investment decisions based solely on the representations of broker dealers or any third party can be dangerous. Management should be required to verify pertinent information about potential investments in brokered CDs and execute verification procedures during the process. On an ongoing basis, the credit union's audit programs should

include a positive direct verification of these investments.

The Board should also establish limits on the volume and types of investments that will be negotiated with each deposit broker. Such parameters are especially important when the investment is other than direct ownership and/or the brokered CD contains unique characteristics.

CONCLUSIONS

The use of brokered CDs can be beneficial if these types of investments are fully understood and managed within a well define plan that conforms to the credit union's asset/liability goals and objectives. During the examination process, Department examiners will review management's policies, procedures, and practices regarding brokered CDs.